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DOW THEORY LETTERS

"The Market as Interpreted under the Dow Theory"

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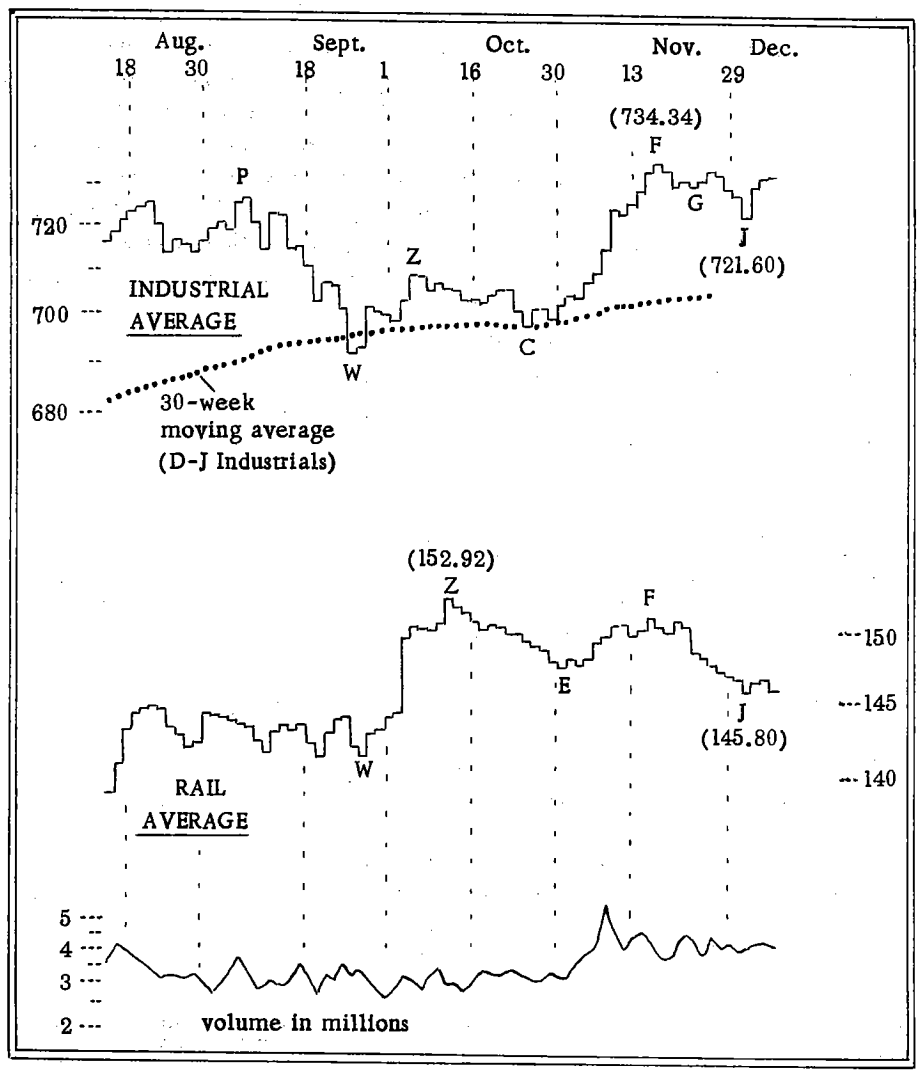
THE MARKET According to the classic precepts of Dow Theory, the movements of the two Averages (Industrial and Rail) reflect the sum total of everything known by anybody which can possibly affect the future of corporate earnings, stock prices and the economy. Those who are unable to accept this principle had better take their leave of technical analysis. For Dow's Theory, when mixed with such fascinating fundamentals as the gold problem, balance of trade, carloadings, etc., becomes a meaningless hodge-podge which is more likely to confuse than clarify. For this reason, these Letters, since their inception, have always begun with discussions of the price movement.

In October, 1961, the Rail Average rose to a peak of 152.92 (Z), and this was followed by an Industrial advance which took the senior Average to an all-time high of 734.34 (F). The joint advance to new highs obviously reconfirmed the primary bull trend. Whenever new highs are established during a bull market, the significance of all previous lows is erased. For this reason, following the new Rail and Industrial peaks, it was necessary for the Averages to establish fresh decline points for purposes of trend analysis.

At point F (see chart), the Rail Average was in an ideal position to better its previous peak at Z (152.92). Such a penetration would have held exceedingly bullish implications and would have had the effect of placing both Averages in new high bull market territory. Obviously, the implications of a new high on the carrier index following close upon the heels of a record price for the Industrial index would have implied that the nation's industrial (manufacturing) and shipping (sales and transportation) facilities were to experience a healthy expansion. Much to the disappointment of market students, the Rails, having touched the peak at F, embarked on a persistent decline. On October 30 the Rail Average recorded a low of 147.63 at E. A brief rally was touched off in early November, but by November 26 the Rail Average had sunk below the E (147.63) level. Thus, Rails traced out a clear descending zigzag and provided one half of a minor bearish signal.



Letter 163 drew attention to the recent divergent movements in the two Averages, and it was stated that "--if Industrials turn down and follow the Rails (particularly as volume increases), the immediate (minor) trend will be considered down." On November 28 the Industrials dropped below the minor decline level at G, thereby confirming the downward tendency of the Rails.

A few things were immediately apparent on the minor Industrial penetration: (1) odd-lot shorts jumped to 5.1 thousand on the day of the penetration, while odd-lotters continued to sell more than they bought, both signs of underlying technical strength. (2) Volume showed no rising tendency as prices declined. (3) There was no "follow through" on the penetration and no signs of urgent liquidation.

 It was also stated in the last Letter that the test of the strength or weakness of the market could well be the ability of the Industrial Average to hold at least half of the C-F gains. Under Dow's 50% Principle, when a decline holds persistently above the halfway point of the preceding advance, the implication is that the upward force has not been spent. For this reason, I had felt that a stubborn refusal by Industrials to break below the 716 level (716 represents the halfway point of the C-F advance) would suggest that the upward force remained unspent.

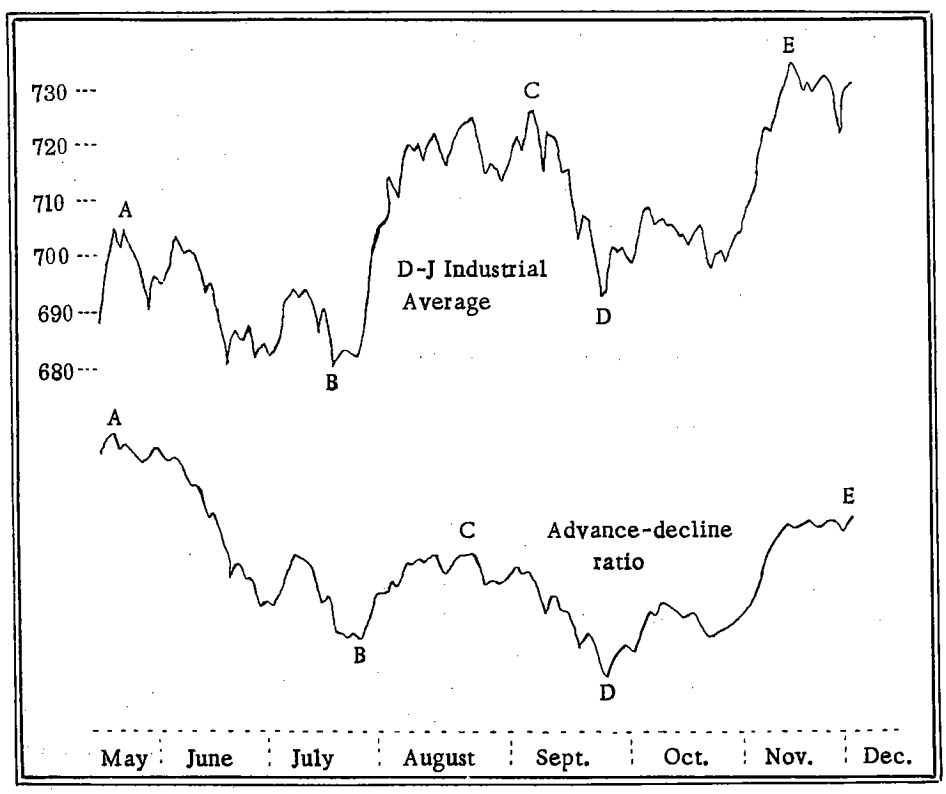
On Friday (Dec. 1) both Averages rallied, and Monday saw a resumption of the upward movement. On the plus side is the fact that the advance-decline ratio has been leading the market higher (December 4 saw the A-D ratio rise to its highest level since June). A second hopeful indication is the fact that odd-lot selling continues unabated. The "flies in the ointment" are twofold: (1) Rails have been lagging badly, and (2) the "new high" index has dropped off fairly sharply despite the recovery high on the A-D ratio. Weakness in the new-high index has often preceded weakness in the A-D ratio, and the latter should be closely watched at this time (see section under "breadth" in this Letter).

CONCLUSION: Although the Rail structure has broken down, Industrials (so far) have been attempting to lead the market higher. If Industrials rise above their all-time peak at F (734.34) and Rails continue up "in gear", we can hope that the air will finally be cleared by a Rail confirmation (first above F - 151.19, then above Z - 152.92). First signs of a real reversal will be a joint violation of the J lows (Industrials 721.60, Rails 145.80) on increasing volume. If the latter occurred, I would be inclined to accept trading profits and losses.

THE PROBLEM OF "BREADTH" Breadth, or the advance-decline ratio (A-D ratio), has been discussed in these Letters on numerous occasions. The A-D ratio measures the advancing or declining tendencies of all the stocks traded on the New York Stock Exchange. The relationship between breadth and the Industrial Average can best be understood if we consider the Industrial Average to represent a "blue-chip" measure of the buying and selling proclivities of informed investors, while breadth is considered to be representative of the sentiment of the public. The latter is true since it takes mass public action to move the entire market (the A-D ratio), while the thirty Dow Industrial stocks can quickly move in direct response to the sentiments of informed investors.

There are a few principles of the breadth-price relationship which have not been covered in these Letters before, and the time is now ripe for such a discussion. Studies over the years show that all declines, whether of minor, secondary or primary importance, have been preceded by a definite divergence between the Industrial Average and the A-D ratio. I urge readers to digest fully the following principles: (1) In those divergent periods where the A-D ratio has recorded a peak unconfirmed by the Industrial Average, the ensuing declines have never been of primary significance. In other words, where the Industrial Average has refused to confirm a new high on the A-D ratio, there have frequently been declines and even severe reactions but never have there been major bear markets. One of the worst declines resulting from such a relationship came in 1934. In April of that year the A-D ratio recorded a high not confirmed by the Industrial Average. A severe reaction resulted, during the course of which the Industrial Average dropped from an April high of 105 to a July low of 85. Thus, even though the broad market had outperformed the Industrial Average, a refusal by Industrials to confirm the A-D ratio resulted in a secondary reaction (but not a bear market).

(2) All major bear markets since the turn of the Century have been preceded by a (downward) divergence in the A-D ratio as Industrials rose to successive peaks. In general, the definite danger signal (based on past history) has been a series of three successive Industrial highs recorded against three successive lows on the A-D ratio. Such marked divergence between the two indicators seems (or has been) sufficient to forecast turns of severe secondary or in many cases primary importance.



Against this background, it is worthwhile studying the current breadth-price relationship. In mid-May, 1961 (point A on chart), both the A-D ratio and the Industrial Average posted peaks. A decline (A-B) followed into July. A second advance (B-C) took the Industrial Average to a new high on September 7, but this high was not confirmed by the A-D ratio. Subsequently, a second decline (C-D) ensued, and here the A-D

ratio dropped to a 1961 low. This low (D) was not confirmed by the Industrial Average. The third advance (D-E) began from the September low, and by November 15 the Industrial Average recorded a third all-time high of 734.34. Note that it was during this advance (D-E) that the A-D ratio bettered its preceding peak at C (this constituted the first hint of improving general market strength).

Nevertheless, the market now faces the technical problem of resolving three successive Industrial highs (A, C, E) with two successive lows on the A-D ratio (B, D). An "all-clear" signal will be given if the A-D ratio can now rise above its May peak at A, thereby confirming the succession of Industrial highs. On the other hand if, during any forthcoming weakness, the A-D ratio drops below its September low at D, the indications will be extremely bearish, and we will then have witnessed three successive lows on the A-D ratio against three successive highs by Industrials. Over the last three weeks it has been consoling to note that the A-D ratio actually performed better than the Industrial Average. It remains, however, for the A-D ratio to prove its strength by hurdling the earlier peak established in May at point A.

TRADING TACTICS While this writer professes no great fondness for "trading", I have, for many months, insisted that commitments in this market should be viewed as trading vehicles -- not as investments "to be put away for the kids". For this reason, I have devoted more than usual space in recent Letters to trading techniques. A common question is -- "If I buy a stock and the market or a stock turns against me, what should I do?" My feeling has always been that when a stock is purchased for trading purposes, the buyer should always pick a mental (or actual) "stop-loss" level, a level below which he is not willing to carry his commitment. By so doing, the buyer will put himself in the position of doing what every solvent trader has learned to do -- admit that he has made a wrong move, chosen a poor stock picked a bad time to enter the market or simply hit a period of "bum luck".

From my own experience, I have found that when I purchase a stock and that stock immediately turns down, I am usually beaten psychologically, and I will generally end up with a loss. For this reason, if the stock which I purchased goes down and provides me with a paper loss from the inception, I will generally sell the stock when it shows a loss of 5 to 7% (plus the cost of commissions). On the other hand, if I buy correctly, and the first direction of the stock is up, I prefer never to be in a position of doing worse than breaking even. This means that if a stock is purchased at 24, and if the next move of that stock is to 26, I will place a mental or actual stop-loss at 25. If my timing and my selection was right, the stock, once having moved out, should not return to 25 (and thus theoretically give the "late-comer" another chance to buy). If the stock continues to move up, then my problem becomes merely one of when to take a profit. Profits may be taken automatically when the stock turns down and violates its 10-week moving average (see Letter 161).

Obviously, the most difficult (and important) procedure in trading is buying correctly. If a stock has been purchased correctly, the worst that should result is that the buyer receives his money back (assuming a rally and then an unexpected reversal). The great difference between the veteran trader and the amateur in a treacherous market is as follows: the veteran trader will show small gains and small losses, whereas the amateur will show a mixture of both small and large losses. Thus, the amateur ends up demoralized both financially and psychologically, while the veteran is in a position "to try again". No one should except to come out ahead in a market that unexpectedly turns down, regardless of the brilliance of his stock selections. The successful trader, however, has learned the wisdom of the old adage, "when in doubt, clear out".

An interesting commentary on the current market is the fact that strong stocks and groups now retain their relative strength for much shorter periods of time than was the case a year or so ago. For instance, when electronics turned strong in 1959 and 1960, the strength lasted for over a year. Conversely, most of us remember the recent short-lived flurries in publishing companies, toy manufacturers, and "shell homes". Current strength in tobaccos and rubbers may already be dissipating. In other words, traders have to be quicker and more prone to change their minds than ever.

STOCKS A measure of the extreme difficulty (selectivity) of the present market can be seen by the fact that of 55 "key" issues which are watched carefully at this office, only 28 are now above their 10-week moving average.

Pennsylvania R.R. (page 4) recently recommended, has broken out of a large "head-and-shoulders" reversal pattern. The breakout came when the stock advanced above the "neckline" (dotted line on chart). To measure the minimum rally expectations, take the distance from the low of the "head" (H) to the neckline, and apply this same distance above the neckline. Using this rule, we get a minimum expectation of 20 1/2 (O on chart) for PA.

Burroughs, suggested as a buy in Letter 162, has broken out of a large triangle and appears to be consolidating its gain. I list BGH as one of the stronger stocks in the market and believe it can still be bought.

Douglas was recommended back in Letter 152. D broke out of the triangle A-B-C and rose to a high for the year at 42 3/8. A decline took D back to the apex of the triangle where support came in (at C). During triangle breakouts, a reversal often occurs, but if the stock is technically strong, support should always come in on a horizontal line extending from the apex (C) of the triangle. D continues to act well, and I believe it may still be bought.

Two Canadian Gold stock, Campbell Red Lake and Dome Mines, have frequently been recommended in these Letters (see Letter 160). Last week Dome Mines rose out of a large triangle and touched a high of 28 1/2. In so doing, it was flirting with the high (29 3/4) of the last fourteen years. Although Dome and Campbell are higher than when previously recommended, I think they represent an intelligent commitment in the gold group. Some of the smaller Canadian companies (discussed as early as Letter 117) have done extremely well. Consolidated Mosher has risen from $1.50 in June, 1960, to a current price of $2.25, Cochenour-Williams from $2.50 to $5.50, Bralorne from $4.80 to $6.00, Barnat from $1.30 to $1.70. Madsen Red Lake, of all of those previously mentioned, has not been a winner. A mixed selection of the first three still represents a good commitment in the current market, although patience may be needed.

Written Wednesday, December 6, 10 A.M.

All individual stock charts courtesy of Traders Research, P.O. Box 6185, Lambert Airport, Mo.